



State of California

2004 Voluntary Compliance Initiative



For Abusive Tax Shelters

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Executive Summary

Inappropriate tax sheltering activity has always existed as a compliance problem for tax administrators. However, in recent years such activities have escalated in size, scope, and sophistication, causing heightened concerns regarding the revenue impacts to state and federal treasuries. This report covers the background of the state tax shelter problem, the results of California's tax shelter amnesty program, and California's strategy to address tax shelters.

In 2004, the State of California offered its first amnesty program aimed at abusive tax shelters. Senate Bill 614 (Statutes 2003, Chapter 656) authorized the Franchise Tax Board (FTB) to administer the Voluntary Compliance Initiative (VCI), which allowed taxpayers that engaged in potentially abusive tax avoidance transactions to correct their state income tax returns. In exchange for full payment of additional tax and interest, participants avoided criminal prosecution and substantial new penalties.

- ◆ The VCI ran from January 1 to April 15, 2004. The final results were 1,202 taxpayers reported \$1.4 billion in additional tax liabilities by filing 2,289 amended returns for tax years 1990 through 2002. Program expenses totaled \$886,000.
- ◆ The majority of the VCI taxpayers were individuals and accounted for 67% percent of VCI participants and 65% percent of total VCI revenues. Corporations, banks, and pass through entities were the remaining participants.
- ◆ Approximately 175 taxpayers audited for tax shelter issues participated in the VCI. They accounted for \$531 million in VCI revenues.

California's strategy to address the tax shelter problem contains three components: compliance, detection, and enforcement. FTB worked closely with the Internal Revenue Service and other state tax agencies in all of these components. This report covers California's activities before, during and after the VCI as of its June 30, 2004 fiscal year end.

Background

Size of the Problem

The FTB administers the Personal Income Tax and the Corporation Tax programs that account for a majority (\$44.7 billion, or 59%, in fiscal year 2003/2004) of California's General Fund revenues. These tax programs rely on taxpayers voluntarily assessing the correct amount of taxes so California can fund state programs such as education, transportation, and public hospitals. However, individuals and businesses increasingly use sophisticated transactions to avoid or evade income tax. This trend poses a serious threat to the efficacy of the tax system because of the loss of revenue and integrity in the voluntary compliance system. Although it is difficult to estimate the fiscal impact of abusive tax shelters on the tax system, the following estimates illustrate the size of the problem:

- Federal government lost about \$85 billion over the last decade¹,
- States lost \$10 to \$17 billion due to corporate income shelters in 2001.²
- California lost \$2.4 to \$4 billion between 1999 and 2003.

Today's Generation of Tax Shelters

The tax shelter schemes that proliferated in the 1980's were relatively simple and straightforward transactions. Promoters promised deductions and credits in over-inflated amounts to tens of thousands of investors sheltering relatively small amounts per person. The current generations of tax shelters are complex technical transactions often coupled with aggressive interpretations of state and federal income tax laws. Tax professionals devised these tax shelters to bury their complexities in multiple layers of entities to escape detection. They packaged them as generic tax products with boilerplate legal opinions for mass marketing, sold them to thousands of taxpayers to generate millions of dollars in fees, and reduced by hundreds of millions of dollars the amounts their clients paid in state and federal taxes³.

The IRS provides public guidance on transactions deemed abusive with a designation known as a "listed transaction". In 1998, there were 5 listed transactions. By 2004, there were 30. Taxpayers and tax professionals ignored the IRS' guidance of unacceptable tax positions, and continued marketing abusive tax shelters at a disturbing rate. For example:

- In December 1999, the IRS issued Notice 99-59 to curtail the Bond and Option Sales Strategies (BOSS). A major accounting firm designed and marketed BOSS to shelter gains through a complex series of sale, loan and dividend arrangements.
- By August 2000, the IRS issued Notice 2000-44 to crack down on variations of BOSS (Son of BOSS) designed to escape provisions of the 1999 IRS Notice. Other accounting

¹ U.S. General Accounting Office Report 04-104T "Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters", October 21, 2003.

² Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections, Multistate Tax Commission, July 15, 2003. Estimate updated during June 2004, MTC States Compliance Initiative, Bruce Johnson, Chair of MTC.

³ "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals", Report prepared by the Minority Staff of the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs (U.S. Senate) dated November 18 & 20, 2003.

or legal firms marketed these BOSS variations and used short sales, digital options, and loan premiums to shelter gains.

- Although the IRS issued new regulations to deter such abuses in 2001 and 2003, promoters continued to design new strategies to escape application of the IRS notices and regulations and more variations of BOSS were born (using different financial instruments to create artificial tax losses, such as market linked deposits).

California State Controller Steve Westly stated, “The transactions we are seeing are so complicated that a typical taxpayer wouldn’t dream them up. Financial experts are going to great lengths to devise complex deals and push them on taxpayers through their partners and even through seminars.”⁴ The IRS estimates that just one of the listed transactions artificially reduced about \$6 billion in taxes for several thousand taxpayers.⁵

California Takes Action

Taxpayers will continue to engage in tax avoidance transactions and tax professionals will continue to market them as long as the risks are not significant. Previously, California had little effect on deterring investments or promotions of abusive tax transactions since the risk of being caught was low and the penalty regime was insignificant compared to the tax reductions realized by investors. These lost tax revenues had a detrimental effect on California’s budget situation since income tax revenues are a large part of California’s general fund account. By the end of 2002, California's audit inventory of tax shelter cases rose exponentially. It was apparent California needed stronger measures to reduce the escalating number of tax shelters.

As California considered legislative solutions, United States Senator Charles Grassley introduced legislation⁶ proposing tools to combat abusive tax shelters. Grassley's proposal served as a blueprint for California's legislation. However, California needed to act fast since the shelter activity occurred predominantly in 1999 and 2000, when the California economic capital gain income rose from \$93 billion in 1998 to \$164 billion, and \$200 billion respectively. Many high-income taxpayers sought to reduce their income taxes through shelters during these years. With the state statute of limitations quickly closing for the tax years with the highest levels of abuse, California could not wait for federal legislation and, on October 2, 2003, California enacted its pioneering tax shelter legislation⁷. The new law increased the risks and costs of using and promoting tax shelters, increased California's detection and enforcement tools and authorized a tax shelter amnesty program. The provisions jump-started California's detection and enforcement strategies while the administration of the VCI augmented self-compliance with minimal use of state resources.

The next section discusses the results of California’s VCI.

⁴ Statement by State Controller Westly in Press Release dated November 18, 2003.

⁵ “IRS Offers Settlement for Son of Boss Tax Shelter” IR-2004-64, May 5, 2004.

⁶ S.476, the CARE (Charity Aid, Recovery, and Empowerment) Act of 2003 108th Congress, first session) introduced on February 27, 2003 by Senator Charles E. Grassley (R-IA). See Title VII Revenue Provisions. Subtitle A Provisions Designed to Curtail Tax Shelters.

⁷ Senate Bill 614 (Statutes 2003, Chapter 656) authored by Senators Cedillo and Burton and Assembly Bill 1601 (Statutes 2003, Chapter 654) authored by Assembly Member Frommer). Both bills contain identical provisions.

Voluntary Compliance Initiative Results

The goal of the VCI was to promote self-compliance and accelerate revenue. The VCI allowed taxpayers who used an abusive tax avoidance transaction to correct their state income tax returns in exchange for avoiding criminal prosecution, lengthy litigation, and substantial penalties. The FTB conducted the VCI between January 1, 2004 and April 15, 2004.

Analysis of Revenue Received

During the VCI, 1,202 taxpayers reported \$1.4 billion in additional tax and interest from potentially abusive tax shelters. Individuals (804) and trusts (56) reported \$973 million (68%) in Personal Income Tax revenues. Corporations, banks, and pass through entities reported \$465 million (32%) in Corporation Tax revenues.

Table 1: Individuals are Majority of VCI Taxpayers and Revenues

Tax Program	Number of Taxpayers	Amounts (in millions)
Personal income tax	860	\$973
Corporate income tax	342	\$465
TOTAL	1,202	\$1,439

The three most notable outcomes were:

- Total revenues exceed a billion dollars.
- 90% of revenues are currently undisputed.
- 40% of VCI taxpayers waived their rights to appeal VCI amounts.

Total revenues exceed expectations

The billion dollars of self-assessed tax reported in the VCI exceeded expectations. Original estimates of potential VCI revenue were \$90 million. FTB audit staff noticed that relatively few taxpayers were involved in the tax shelter audit cases, but the amount of taxes they underreported were large- often close to a million dollars. While it was not clear how many taxpayers would eventually participate in the VCI, the number of taxpayers was not the key factor in any potential success of the initiative. The key factor to its success and the greatest impact to compliance was the average underpaid tax liability per taxpayer. Although some taxpayers reported overpayments, and some reported additional tax liabilities of tens of millions of dollars, the average VCI underpaid tax liability reported per taxpayer was slightly more than \$1 million. The \$1.4 billion in additional taxes resulted from taxpayers reporting an increase of approximately \$14 billion in California taxable income.

Many taxpayers seek to avoid consequences

California considered different components to spur the highest probability of VCI participation. During its cooperative efforts with tax professionals, California learned that relieving penalties would not suffice to entice taxpayers into compliance when investors and promoters believed detection was unlikely and penalties were inconsequential. To address this concern, California combined the VCI with the highest tax shelter penalties in the nation, applied some of them retroactively, and increased its cooperative enforcement efforts nationally. While raising the

stakes of not participating in the VCI, California also minimized taxpayers' participation risks by providing different options and, in some cases, allowing them to retain the right to dispute any tax agency findings.

Taxpayers had two choices when they participated:

- Avoid all penalties and waive their right to dispute the tax shelter amount (referred to as Option 1), or
- Maintain their right to dispute the tax shelter amount, and remain subject to one penalty (referred to as Option 2).

Table 2: VCI Allows Taxpayers Options to Participate

Is the VCI Taxpayer	VCI OPTION 1	VCI OPTION 2
Subject to New Increased Tax Shelter Penalties?	No	No
Subject to Accuracy Related Penalty?	No	Yes
Able to Appeal?	No	Yes

FTB's historical experience is that taxpayers do not voluntarily change their positions unless they can dispute the result. However, a significant percentage of VCI taxpayers (40%) chose to forego all appeal rights (Option 1) and reported \$355 million in VCI revenues.

Table 3: 40% of VCI Taxpayers Avoid All Penalties

Tax Program	Taxpayers electing Option 1	Taxpayers electing Option 2
Personal income tax	321	539
Corporate income tax	161	181
TOTAL	482	720

Small numbers of taxpayers dispute their VCI amounts

While 720 VCI taxpayers chose Option 2 (\$1.08 billion of VCI revenues) and kept their right to dispute the amounts reported in the VCI, only 36 taxpayers filed claims for refunds totaling \$42 million. As with any other self-assessed return, the remaining Option 2 taxpayers may file claims for refunds within the normal state statute of limitations⁸.

Other notable findings

VCI was applicable for all tax years before tax year 2003. The majority (77%) of the VCI revenues (\$1.1 billion) were attributable to tax years 1999 through 2001. This indicates the majority of VCI revenues came from the tax years with the largest amounts of capital gains. However, a surprising \$148 million (10%) was for tax years normally closed by the statute of limitations (tax years preceding 1999). Some taxpayers may have amended older tax years if

⁸ California Revenue and Taxation Code Section 19306; one year from overpayment, or 4 years from the due date of the original return, or date filed, whichever is later. See CR&TC Section 19311 for filing refunds based on federal changes.

Over \$300 million in VCI revenues came from taxpayers in states other than California. This reinforces government findings that taxpayers across the country are engaged in abusive tax shelters. Graph 1 shows the distribution of California VCI revenues received from around the nation, with amounts greater than \$1 million noted on the map. [Appendix B.7.6](#) provides further detail of amounts reported by states.



At the beginning of the VCI, California had over 400 audits opened or pending with tax shelter issues. About 150 of the taxpayers under audit participated in the VCI and reported almost \$500 million owed. About 25 additional taxpayers protesting or appealing their tax shelter assessments also participated in the VCI. They voluntarily reported \$31 million owed and had \$5 million in accuracy-related penalties waived to close their cases. Overall, the VCI accelerated the resolution of 175 cases for \$531 million.

Taxpayers who chose Option 2 remain subject to the accuracy-related penalty when FTB disallows any refunds for amounts paid in the VCI. In addition, any proposed deficiency

assessments to VCI taxpayers for tax shelter amounts not reported in the VCI are subject to two of the new tax shelter penalties:

- (1) Noneconomic Substance Transaction penalty⁹
- (2) Interest Based penalty¹⁰.

Forgone Revenue

Under Option 1, California agreed to forgo certain penalties totaling approximately \$55 million. Unlike the general amnesty programs that determine forgone revenue by the amount of penalties assessed but waived under amnesty, the amount of revenue forgone for VCI purposes includes a subjective determination regarding potential penalty amounts. The estimate of forgone revenue is based on the amount of additional tax reported by Option 1 taxpayers and assumes FTB would have:

- Audited and disallowed the tax shelter issue, and
- Assessed the accuracy-related penalty¹¹.

As a result of taxpayers participating in the VCI, FTB waived \$5 million in penalties previously assessed on notices of deficiency. This amount is included in the estimate of \$55 million.

Revenue loss due to redirection of resources from normal audit workloads to abusive tax shelters was addressed as part of the audit workplan process. Since the VCI effort was part of the universe of abusive tax shelter workloads, there is no additional revenue loss¹² from the redirection of resources.

Program costs

To administer the program, FTB staff spent over 19,000 hours (or 11 personnel years) on implementation activities to administer the VCI program for total program costs of \$886,000.

The next section discusses California's strategy for addressing abusive tax shelters.

⁹ California Revenue and Taxation Code section 19774.

¹⁰ California Revenue and Taxation Code section 19777.

¹¹ For this estimate, only the accuracy related penalty is used since that penalty was the only penalty applicable to the audit inventory before the passage of the tax shelter legislation (SB 614). Without the legislation, we would not have the VCI or the increased tax shelter penalties to assess.

¹² This does not include revenue loss from displaced workloads.

California's Strategy for Addressing Abusive Tax Shelters

California used a comprehensive strategy to maximize compliance while conserving resources based on lessons learned from other agencies. Our strategy consisted of three primary components:

- Compliance mechanisms to promote self-compliance and discourage buying and selling of abusive tax shelter products.
- Detection efforts to identify noncompliant taxpayers.
- Enforcement measures to address taxpayers continuing to engage in abusive transactions.

Compliance Strategy

In 2001, California identified about 40 tax shelter cases. In less than two years, this number swelled to 400 tax shelter cases. California sought new compliance strategies since its traditional business approach would not suffice.

Taxpayers were encouraged to voluntarily amend returns for tax shelter items to minimize penalties. When the IRS announced its Offshore Voluntary Compliance Initiative (OVCI) in 2003, California was the first state to support taxpayer participation in the IRS initiative by offering participants similar relief if they also corrected their California tax returns. This resulted in California taxpayers voluntarily reporting over \$5 million in accelerated state tax revenues.

In July 2003, the University of California, Davis Center for State and Local Taxation, the California Research Bureau California State Library, and the FTB held an Abusive Tax Schemes Symposium to an audience of media, legislators, and tax practitioners. The symposium centered on the depth of the tax shelter problem and current government enforcement activities, including the lack of effective deterrents and loopholes that allowed tax shelter investors and promoters to escape significant penalties. The symposium helped convince the media, legislators and tax professionals of the need for tougher measures to encourage self-compliance and penalize those playing “audit roulette.”

California officials worked with academia and tax professionals to examine the tax shelter phenomenon and identified ways to combat the problem. Various federal legislative proposals were reviewed and a modified version was chosen to address issues facing California. On October 2, 2003, California enacted tax shelter legislation that provided vital tools needed to curtail abusive tax shelters.

The new law provided a comprehensive approach to combating abusive tax shelters by including incentives to comply and severe consequences for continued noncompliance. The main purpose of the law was creating the VCI, which allowed taxpayers to comply before California advanced its enforcement efforts. The law includes sizeable new penalties and a reporting regime patterned after the federal requirements for disclosing potentially abusive transactions. These provisions are summarized below. The entire text of the new law is at [Appendix A.5](#).

Voluntary Compliance Initiative ([Appendix A.1](#))

- Offered January 1, 2004 through April 15, 2004.
- Provided taxpayers two options to participate.

Penalties ([Appendix A.2](#))

- A retroactive penalty based on 40 percent of understatements lacking economic substance.
- A retroactive penalty equal to 100 percent of the accrued interest on deficiencies related to tax shelters.
- A prospective penalty equal to 30 percent of understatements from undisclosed reportable transactions.
- A prospective promoter penalty equal to 50 percent of the promoter's gross income derived from promoting tax shelters.
- Prospective penalties for failing to report, register, or disclose required information regarding abusive tax shelters and transactions.

Reporting Requirements ([Appendix A.3](#))

- Conformed to federal return disclosure and list maintenance requirements for reportable transactions.
- Expanded California's tax shelter registration requirements.
- Required organizers selling listed transactions after February 28, 2000, and before January 1, 2004, to register those transactions and provide California with a list of their investors by April 30, 2004.

Other Curtailments ([Appendix A.4](#))

- Extended from four years to eight the statute of limitations for California to issue a deficiency notice regarding tax shelters effective for open years.
- Eliminated the suspension of interest provisions for tax shelter assessments.
- Expanded the FTB's ability to issue subpoenas to taxpayers involved in abusive tax schemes.
- Expanded the FTB's ability to obtain an injunction against abusive tax shelter promoters from marketing shelters within California.

The FTB publicized the VCI to maximize public awareness of and participation in the program. FTB staff focused the marketing campaign on the members of the public most likely to participate in the VCI, informing them of the VCI, the consequences of continued failure to comply, and the new reporting requirements. Between December 2003 and March 2004, approximately 32,000 letters¹³ were mailed to taxpayers describing the benefits of the initiative. Recipients included taxpayers, practitioners, partners of law and accounting firms, and leads received from the IRS, other states and other sources. Additional letters were mailed to tax professionals and potential tax shelter promoters outlining the new reporting requirements and penalties.

Taxpayers also were encouraged to participate through news conferences, press releases, and presentations to tax professional organizations. California State Controller Steve Westly held

¹³ See [Appendix B.6](#) Franchise Tax Board VCI Letters

three news conferences publicizing the VCI and encouraged participation to avoid penalties later. Media activities resulted in California obtaining over 100 print stories (some in nationally syndicated papers), 9 radio and television stories, and 20 Internet news stories¹⁴.

We implemented a variety of information resources for taxpayers and tax practitioners:

- An Abusive Tax Shelters webpage on the Internet (FTB's website) provided timely and relevant information for taxpayers, practitioners and promoters. The website contained publications, frequently asked questions¹⁵, summary of relevant penalties, reporting requirements, links to IRS information and other public information on the abusive tax shelter program.
- VCI brochures¹⁶ distributed through public service offices and tax professional forums.
- A VCI telephone hotline and e-mail address answered over 1,100 telephone calls and 100 email inquiries.

Detection Activities

In September 2003, California and 48 other states signed a Memorandum of Understanding (MOU¹⁷) with the IRS for sharing information and coordinating enforcement efforts relating to abusive tax avoidance transactions. The MOU enhances the exchange of information on compliance initiative programs, litigation, types of schemes, investor and promoter lists, staff training and publicity. In February 2004, the IRS provided over 20,000 tax shelter leads to state taxing agencies on taxpayers involved in offshore transactions, abusive trusts, employee leasing, home-based businesses, employment taxes and other tax-avoidance schemes. Through the agreement, the IRS provides information to the states on a semi-annual basis. Publicizing the sharing of these leads and reinforcing the cooperation between tax administrators helped spur taxpayer interest in California's VCI.

On March 4, 2004, California, and other participating states ratified a Memorandum of Agreement (MOA¹⁸) to share information about abusive tax schemes. As of June 2004, 41 states, the District of Columbia and the City of New York joined in the agreement. The MOA streamlines and facilitates the exchange of information among the states, promotes consistency, maximizes resources and prevents duplication of effort. The MOA allows the states to share names of participants in abusive tax schemes, training materials, and other related information. The states share information through a central database.

California's tax shelter legislation increased the reporting and disclosure requirements for potentially abusive tax shelters. It also broadened the number of tax shelters required to register with California to include transactions with any connection (income, business activity, investor) to California. To increase California's knowledge of those who used potentially abusive tax shelters, the legislation added a requirement for organizers who sold any listed transactions since

¹⁴ See [Appendix C](#)

¹⁵ See [Appendix B.4 for the Frequently Asked Questions](#)

¹⁶ See [Appendix B.5 for the Franchise Tax Board VCI Brochure](#)

¹⁷ See [Appendix D.1. for a complete copy of the IRS MOU](#)

¹⁸ See [Appendix D.2. for a complete copy of the states MOA](#)

February 28, 2000¹⁹ to automatically provide a list of the taxpayers purchasing those transactions.

Enforcement Activities

California is vigorously pursuing tax shelter audits and expanding its focus on curtailing abusive tax shelters. A key strategy is to complement the enforcement activities of the IRS and other states, seeking joint opportunities to maximize efficiencies and avoid duplication by:

- Coordinating audit activities with IRS and other states.
- Utilizing technology solutions to effectively identify audit candidates.
- Conducting joint promoter audits with the IRS and other states to obtain information regarding investors, promoters, marketing strategies, and technical arguments.
- Issuing subpoenas, if necessary, to get information needed to complete our examinations.

Equipped with sizeable new penalties, we began to crack down on promoters of abusive tax shelters. In early 2004, we issued subpoenas and requested client lists from insurance companies believed to be insuring clients who invested in abusive tax shelters against government action.

In August 2004, the FTB jointly hosted an abusive tax shelter symposium with the Multistate Tax Commission and the Federation of Tax Administrators. The symposium enhanced partnering relationships between the 29 attending states and the IRS while accelerating awareness of the national problem and solidified the commitment of the taxing agencies to boost their curtailment efforts. As a result of the success of the VCI program, other states have sought similar legislation.

To further focus our enforcement efforts, FTB formed an Abusive Tax Shelter Unit and supporting teams to keep our information on abusive tax shelters up to date. To ensure we remain have the best information, FTB retained consultants including economists, appraisers and other financial experts to help staff unravel the complex tax schemes.

VCI Lessons Learned

California learned many important lessons while administering the VCI. The knowledge among tax advisors that there is no better deal waiting down the road is critical to the success of any initiative. The following lessons learned may assist other tax officials seeking to administer a tax shelter initiative:

- Dedicate funds and experienced resources to target abusive tax shelters.
- There is no quick fix. Tax shelter issues are constantly evolving, so your overall program strategy must be flexible. In addition to implementing the initiative, long-term resources and funding are needed for detection and enforcement.
- Actively coordinate communications within your department and with other taxing agencies. Information sharing is critical to detection and enforcement efforts. Noncompliant taxpayers thrive on silence.

¹⁹The reference to the February 2000 date is based on the changes to the Treasury regulations involving reportable transactions; Treasury Regulations Sections 1.6011, 1.6111 and 1.6112.

- Gain the authority to take the strong actions needed to influence taxpayer behavior. Adequate enforcement tools are required. Individuals creating, promoting and using abusive transactions are rarely swayed by penalties, reporting requirements or demands for information unless there are significant consequences and those consequences are enforced. . Noncompliant taxpayers and advisors bet that tax administrators will be too strapped and under-funded to take effective action. They must be proven wrong.
- Publicize your department's actions in cracking down on abusive tax shelters to create credibility. Take an active role in directing publicity to those taxpayers most likely to participate. A taxing agency's message must be clearly stated and consistently sent. Inconsistent messages or treatment dilute the effectiveness of any compliance or enforcement effort.
- Detection and enforcement are key to an effective response. An initiative administered without strong detection and enforcement efforts will likely not succeed.

The next section compares California's VCI with the Internal Revenue Service's tax shelter initiatives.

Comparison with Internal Revenue Service Tax Shelter Initiatives

Most state tax amnesty programs are open to the general taxpaying public for various types of taxes. However, no other state had previously opened an amnesty program for taxpayers using abusive tax shelters. Therefore, there are no statistics available to compare California's VCI with tax shelter initiatives from other states (at the time this report was prepared).

The IRS is the only other tax agency that offers initiatives for abusive transactions. They carefully design their tax shelter litigation and settlement strategies for each transaction based on a fair assessment of the litigation hazards to the government and to the taxpayer. A decision to pursue a settlement initiative as to any particular tax avoidance transaction requires careful analysis and balancing of all competing interests and considerations.

Settlement initiatives for abusive tax avoidance transactions may significantly affect taxpayers' voluntary compliance and public confidence. The voluntary compliance system depends on taxpayers knowing tax administrators enforce the tax law against everyone. The IRS increased their enforcement efforts to focus on the rise of abusive tax avoidance transactions and publicized their numerous enforcement successes. The following IRS activities highlighted the size of the problem, the seriousness of the government crackdown, and served as a catalyst for California's success:

- From December 2001 to April 2002, a disclosure initiative resulted in 1,690 transaction disclosures from 1,212 taxpayers. The disclosed transactions involved \$30 billion in claimed losses and deductions.
- From October 2002 through March 2003, other initiatives allowed taxpayers engaged in corporate owned life insurance (COLI), IRC sections 302 and 318 basis shifting, and IRC section 351 contingent liability transactions to resolve their tax consequences arising from their participation in these transactions.
- Since 2002, IRS Large and Mid-Size Businesses Division issued hundreds of administrative summonses in numerous promoter cases. They also obtained court order approval to serve John Doe summonses and the Justice Department filed summons enforcement actions against several promoters.
- From January 2003 through April 2003, an initiative allowed taxpayers using abusive offshore financial arrangements and products to escape criminal prosecution if they disclosed their promoter information. More than 1,300 taxpayers applied and so far the initiative has yielded more than \$170 million in taxes, interest and penalties. The IRS obtained the names of 479 promoters, nearly half of them previously unknown.

The next section concludes this report.

Conclusion

The California Voluntary Compliance Initiative for abusive tax shelters was successful by several measures. While it broke national records for revenues reported during an initiative, the biggest success was self-compliance. During the brief period of the VCI, over 1,200 taxpayers—business entities and individuals—filed over 2,200 amended returns to eliminate tax shelter benefits and comply. Correcting these transactions provided California with \$1.4 billion in income tax revenues.

The VCI's success is largely due to the comprehensive approach of combining a compliance incentive with strong consequences to achieve desired behaviors. The joint efforts with the IRS and other state taxing agencies provided California lawmakers with the information they needed to enact the toughest enforcement and penalty provisions combined with a one-time compliance offer. Together, these provisions have allowed California to make a large impact on abusive tax shelters for returns already filed, while allowing California tax officials to more efficiently pursue future abusive tax shelter transactions.

California remains diligent in its compliance and enforcement efforts and is taking a united approach with the IRS and other state tax administrators in combating abusive tax avoidance transactions.

Addendum

Since April 2004, post-VCI activities at the federal level include:

- IRS offered a settlement initiative for investors of Son of Boss transactions. The IRS announced on May 5, 2004 that taxpayers had until June 21, 2004 to file Notices of Elections to settle. Over 1,500 taxpayers participated, which is about 85% of the Son of Boss taxpayers known to the IRS. See [Appendix D.2.3](#) for more information.
- President Bush signed the American Jobs Creation Act of 2004 that contained tax shelter penalty and curtailment provisions. See [Appendix A.6](#) for a chart comparing the new federal tax shelter provisions to California's current tax shelter provisions.

Since April 2004, post-VCI Activities among the states include:

- California received the following information from their new reporting requirements:
 - 2,000 disclosures of reportable transactions (IRS Form 8886).
 - 950 tax shelter registrations (IRS Form 8264).
 - 9,900 client names who participated in reportable transactions
- [Connecticut](#) ran an abusive tax shelter compliance initiative from June 16, 2004 through July 31, 2004. Taxpayers had until September 30, 2004 to submit information. No final results posted.
- Illinois enacted a [Voluntary Compliance Program](#) (VCP) to give taxpayers an opportunity to file and pay any tax liability from participating in a tax avoidance transaction before their new penalties related to abusive tax shelters go into effect. The VCP started October 15, 2004 and ends January 31, 2005.
- Four additional states signed the States Abusive Tax Shelter Memorandum of Agreement bringing the total to 45 states plus New York City and District of Columbia. The five

states that had not signed the agreement were Florida, Mississippi, Nevada, New Hampshire, and Wyoming.

- Based on the States Abusive Tax Shelter Memorandum of Agreement, New York Department of Revenue completed the Multi State Tax Shelter (MSTS) Application. The MSTS is a secure web-based database allowing states to exchange data on tax shelter participants and information.

Appendices

Appendix A - California Law Statutes 2003, Chapter 656 (Senate Bill 614)

- A.1 Voluntary Compliance Initiative provisions
- A.2 Penalty provisions
- A.3 Reporting Requirement provisions
- A.4 Other curtailment provisions
- A.5 All provisions of Senate Bill 614
- A.6 Chart comparing federal H.R. 4520 to California SB 614

Appendix B -Voluntary Compliance Initiative

- B.1 Participation Agreement (Individuals) and Instructions (Form FTB 622)
- B.2 Participation Agreement (Business Entities) and Instructions (Form FTB 621)
- B.3 Request for Chief Counsel to Relieve Penalties (Form FTB 626)
- B.4 Frequently Asked Questions
- B.5 Franchise Tax Board VCI Brochure
- B.6 Franchise Tax Board VCI Letters
 - B.6.1 Letters mailed to Promoters in February 2004
 - B.6.2 Letters mailed to Other Leads in February 2004
 - B.6.3 General notification letters mailed in March 2004
- B.7 VCI graphs and charts of statistics
 - B.7.1 Summary of VCI by Options- Chart
 - B.7.2 Summary of VCI Revenues by Options- Graph
 - B.7.3 Summary of VCI Taxpayers by Options- Graph
 - B.7.4 VCI Returns by Tax Year- Graph and Table
 - B.7.5 Analysis of VCI by Taxpayer Type-Graph
 - B.7.6 Summary of VCI Participation by States-Table
 - B.7.7 Summary of VCI Participation by Taxpayer Type
 - B.7.8 Illustration of Tax Shelter Penalties before and after legislation

Appendix C - Media

- C.1 Franchise Tax Board Press Releases
 - C.1.1 July 15, 2004-FTB Adds Tax Expert to Its Abusive Tax Shelter Team
 - C.1.2 June 10, 2004-Westly Tax Cheat Crackdown Shrinks Budget Gap
 - C.1.3 April 22, 2004-Westly Announces \$838 Million Windfall Will Help Budget Deficit
 - C.1.4 April 15, 2004-Penalty-Free Program for Tax Shelters Ends Today
 - C.1.5 April 12, 2004-State to Serve First of Tax Shelter Subpoenas
 - C.1.6 April 09, 2004-Illegal Tax Shelter Crackdown Tops \$200 Million Mark
 - C.1.7 April 7, 2004-Controller Westly, Board Of Equalization Member Chiang, Majority Leader Frommer Warn Corporate Tax Cheats Of Stiff Penalties For Illegal Tax Shelters

- C.1.8 March 25, 2004-CPA Firms Targeted in Abusive Tax Shelter Crackdown
- C.1.9 March 22, 2004-Taxpayers Under IRS Audit Urged to Apply for VCI - Penalty Waiver
- C.1.10 March 17, 2004-Westly Proposes \$1 Billion Plan to Help Close Budget Gap
- C.1.11 March 11, 2004-Latest Tax Shelter Crackdown Targets Promoters
- C.1.12 March 04, 2004-States Sign Anti-Abusive Tax Shelter Agreement
- C.1.13 February 19, 2004-Illegal Tax Shelter Crackdown Hits \$100 Million
- C.1.14 February 9, 2004-FTB Information Releases
- C.1.15 January 22, 2004-States Huddle to Plan Offensive Against Abusive Tax Shelters
- C.1.16 January 07, 2004-Tax Shelter Crackdown Nets \$30 Million
- C.1.17 December 03, 2003-New Program Cracks Down on Illegal Tax Shelters
- C.1.18 November 11, 2003-Controller Westly Sends Tax Shelter Expert to Testify at Congressional Hearing
- C.1.19 September 9, 2003-State and Feds Partner to Crackdown on Illegal Tax Schemes
- C.1.20 August 5, 2003-California Targets Abusive Tax Shelters with New Round of Audits
- C.1.21 March 14, 2003-No Jeopardy for State Taxpayers who participate in the IRS' Offshore Voluntary Compliance Initiative, says FTB
- C.1.22 February 10, 2003-FTB Urges Participants in the IRS' Offshore Voluntary Compliance Initiative to Correct State Returns Too
- C.2 Television Programs
 - C.2.1 CBS 60 Minutes-transcript
 - C.2.2 PBS Frontline-transcript

Appendix D - References

- D.1 United States Congress
 - D.1.1 United States Tax Shelter Industry: The Role of Accountants, Lawyers, And Financial Professionals-Four KMPG Case Studies: FLIP, OPIS, BLIPS, and SC2
 - D.1.2 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. I
 - D.1.3 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. II
 - D.1.4 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. III
 - D.1.5 U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals-Vol. IV
 - D.1.6 Fishtail, Bacchus, Sundance, & Slapshot: Four Enron Transactions funded by U.S. Financial Institutions January 2, 2003
 - D.1.7 Testimony of Debra Petersen of the California Franchise Tax Board before the United States Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs on November 18, 2003

- D.1.8 Testimony of Debbie Langsea of the California Franchise Tax Board before the United States Senate Finance Committee on July 21, 2004
- D.2 Internal Revenue Service
 - D.2.1 Internal Revenue Service Abusive Tax Avoidance Transactions Memorandum of Understanding
 - D.2.2 United States General Accounting Office Report, April 2002, Internal Revenue Service, Enhanced Efforts to Combat Abusive Tax Schemes- Challenges Remain.
 - D.2.3 IRS Son of Boss Settlement Information
- D.3 States
 - D.3.1 State Abusive Tax Avoidance Transaction Memorandum of Agreement
 - D.3.2 State of Connecticut Abusive Tax Shelter Compliance Initiative
 - D.3.3 State of Illinois Voluntary Compliance Program